BILL # SB 1546 | **TITLE:** investment tax; phaseout

SPONSOR: Martin | **STATUS:** As Introduced

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FISCAL ANALYSIS

Description

SB 1546 would provide an individual and corporate income tax exemption for net capital gains. Beginning in calendar year (CY) 2006, the exemption would equal 10% of net capital gains. The percentage exempted would increase by 10% each year until state income taxes on net capital gains would be fully phased out in CY 2015.

Estimated Impact

This bill is estimated to reduce individual income taxes by $(39) million and corporate income taxes by $(17) million, for a total of $(56) million, in FY 2007. In FY 2016, when state income taxes on capital gains would be fully phased out, the total General Fund revenue loss would be $(637) million. The table below shows the estimated annual impact by income tax category.

Estimated General Fund Revenue Loss ($ Millions)

Fiscal Year	Individual Income Tax	Corporate Income Tax	Total Income Tax
2007	$(39)	$(17)	$(56)
2008	(81)	(27)	(108)
2009	(142)	(41)	(183)
2010	(133)	(54)	(187)
2011	(202)	(70)	(272)
2012	(251)	(85)	(336)
2013	(303)	(102)	(405)
2014	(359)	(120)	(479)
2015	(418)	(139)	(557)
2016	(482)	(155)	(637)

This analysis is based on an estimate of federal capital gains collections. The federal capital gains tax rate is scheduled to increase from 15% to 20% in FY 2010. If the federal government extends the 15% rate, capital gains could be higher than anticipated. As a result, the bill's individual income tax impact could be understated by about 25% each year starting in FY 2010.

These estimates are based on a static model and do not incorporate "dynamic" estimates. Dynamic forecasting goes beyond the static approach and attempts to predict changes in the economy brought about by changes in tax policy. The income tax reductions would lead directly to significant increases in households' disposable income and after-tax corporate profits. These increases would stimulate increased consumer and capital spending that would lead to higher levels of employment, construction, personal income, and additional revenue from sales, property, and insurance premium taxes. In addition, an even broader dynamic model would evaluate the impact of reductions in the growth in state spending resulting from the changes in tax policy. This spending impact, however, is difficult to evaluate until the specific reductions are known.

Dynamic estimates are based on complex econometric models. Based on national research, these models typically generate dynamic revenue feedbacks ranging from 2% to 20% of the static revenue impact within 5 years. In other words, up to 20% of the static revenue loss would be offset by revenues generated by greater economic activity. The specific feedback will depend on the type and magnitude of the tax reduction.

Due to time constraints, this analysis does not include a dynamic forecast for SB 1546. The impact, however, can be expected to fall within the typical dynamic feedback range.

The follow link posted on JLBC's website contains a document that provides a description of recent developments in dynamic revenue forecasting, including some results reported in other states: http://www.azleg.gov/jlbc/m-RevForecasting.pdf

The Department of Revenue's analysis of SB 1546 is not yet available.

Analysis

Individual Income Tax

According to Statistics of Income (SOI) data released by the Internal Revenue Service, net capital gains comprised 4.4% or $4.6 billion of the total federal adjusted gross income (FAGI) reported by Arizona individual income taxpayers in tax year 2003. SOI data for capital gains earned by Arizona residents in tax years 2004 and 2005 is not yet available. Instead, this analysis uses preliminary figures for tax year 2004 and estimates for tax years 2005 to 2015, as reported in the *Budget and Economic Outlook* published by the Congressional Budget Office (CBO) in January 2006. While CBO does not provide forecasts for individual states, Arizona capital gains growth closely tracks national growth.

Using this approach, it is estimated that Arizona net capital gains grew by 48.3% in tax year 2004 and 12.5% in tax year 2005. CBO's projected average annual growth rate for the period between 2006 and 2015 is 2.3%. The growth rate in individual years varies between (29.5)% and 21.3%. In dollar terms, this means that Arizona net capital gains would grow from $4.6 billion in tax year 2003 to $9.6 billion in tax year 2015.

An exact figure of the effective tax rate for Arizona taxpayers that report capital gains on their federal tax returns is not currently known. In a special report on state capital gains published in *State Tax Notes* on August 18, 2003, two economics professors from Georgia State University estimated the amount of Arizona individual income tax revenues attributable to capital gains based on an assumed effective tax rate of 5.04%, which is also the top statutory tax rate for the state. Based on tax year 2003 SOI data for Arizona, this is a reasonable assumption. The SOI data shows that 89% of total net capital gains earned by Arizona taxpayers are for individuals with an income of $100,000 or more. These individuals would typically have an effective tax rate of 5.04%.

The table below shows the estimated amount of individual income tax revenues that the state would lose in each year between FY 2007 and FY 2016 under the bill. For tax year 2006, the tax liability would be reduced by $(39) million, with the corresponding tax revenue loss expected to occur in FY 2007. The loss of individual income tax revenues under SB 1546 would vary by year depending on both the subtraction percentage and the underlying net capital gains forecast. In FY 2016, when the bill would be fully phased in, the state would lose an estimated $(482) million in individual income tax revenues.

Individual Income Tax Reduction under SB 1546 ($ Millions)

Fiscal Year	Net Capital Gains incl. in FAGI	Allowed Subtraction	Amount Subtracted from AGI	Effective Tax Rate	Ind. Income Tax Revenue Loss
2007	$7,799	10%	$780	5.04%	$ (39)
2008	7,998	20%	1,600	5.04%	(81)
2009	9,359	30%	2,808	5.04%	(142)
2010	6,594	40%	2,638	5.04%	(133)
2011	7,998	50%	3,999	5.04%	(202)
2012	8,310	60%	4,986	5.04%	(251)
2013	8,579	70%	6,006	5.04%	(303)
2014	8,891	80%	7,113	5.04%	(359)
2015	9,218	90%	8,296	5.04%	(418)
2016	9,558	100%	9,558	5.04%	(482)

CBO is required by law to base its forecasts on existing federal tax provisions. Under existing federal law, the current 15% long-term capital gains tax rate would expire December 31, 2008, and then revert to 20% beginning in CY 2009. For this reason, CBO's capital gains forecast above assumes a surge of 17% in realized taxable gains in FY 2009, the last year for which the lower tax rate would apply, and a subsequent decline of (29.5)% in FY 2010. However, if Congress enacts legislation that would make the 15% long-term capital gains tax rate permanent, CBO's capital gains forecast in FY 2010 and subsequent years could be understated by about 25%. This means that the individual income tax loss in this analysis for the same period would also be understated by 25%.

Corporate Income Tax

Under current law, the Arizona corporate income tax rate is 6.968% of a corporation's net Arizona taxable income or $50, whichever is greater. SB 1456 would reduce the corporate tax rate on capital gains by 10% per year beginning in tax year 2006 until it is fully phased out in tax year 2015 and after.

The amount of capital gains for corporations filing Arizona income tax returns cannot be determined. While corporations are required to report capital gains on their federal tax returns, the amount is embedded in the federal taxable income total that is entered on their Arizona tax return. In order to be implemented, the capital gains tax reductions provided by the bill would require corporations to report their capital gains when filing their Arizona income tax returns.

The IRS SOI data provide some estimates of corporate capital gains from federal tax returns. The data is compiled from Form 1120 filings, which represent virtually all of corporate taxable income. For tax years 1994 through 2003, the latest statistics available for corporations, reported capital gains varied widely across the business cycle. In this 10-year period, capital gains as a percentage of federal taxable income ranged from 9.9% to 21.5% and averaged 14.5%. For purposes of this analysis, it is assumed that capital gains account for 14.5% of corporate taxable income.

Based on the JLBC FY 2007 Baseline forecast and using these assumptions, a capital gains tax reduction of 10% in CY 2006 and 20% in CY 2007 would reduce corporate income tax liabilities by $(11.8) million and $(25.5) million, respectively. The revenue loss would be higher during tax years following periods of rapid capital asset appreciation and lower when capital gains reflect slower growth in asset values.

It is likely that the full impact of the rate reductions would be realized over 3 fiscal years due to variability in corporate income tax filing deadlines. For purposes of this analysis, 25% of the revenue impact would occur in year 1, 65% in year 2, and 10% in year 3. It should be noted, however, that since the first rate reduction is retroactive to January 1, 2006, the associated 25% revenue impact will not occur until FY 2007. Under this approach, the estimated static impact would be approximately $(17) million in FY 2007 and $(27) million in FY 2008. In FY 2016, when income taxes on capital gains would be fully phased out, the corporate income tax revenue loss would approach $(155) million.

Local Government Impact

Each year incorporated cities and towns receive 15% of individual and corporate income tax collections from 2 years prior. This bill would reduce local government distributions by between $(8.4) million in FY 2009 and $(95.6) million in FY 2018.

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